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# BEAR, STEARNS & CO. INC. EQUITY RESEARCH

# SBC Communications Inc. (SBC 24.88) - Outperform Highlights From Meeting With SBC Management

## **Key Points**

- \*\*\* We met with SBC management today in New York. A full discussion follows.
- \*\*\* UNE-P remains the most important issue affecting the company. Although competition in the Southwestern Bell territories is stable and predictable, Ameritech and California competitive access line losses will likely deteriorate further. SBC management is actively seeking relief in the form of increased (cost-based) wholesale UNE pricing.
- \*\*\* SBC is investing in hopes of organically growing its enterprise market capability. However, management estimates that the company is at least 18 months away from having a meaningful enterprise market product set and five years from gaining traction in the marketplace. AT&T was identified by the company as the acquisition target of choice to speed market entry, but many hurdles exist.
- \*\*\* Footprint and spectrum constraints are the major issues facing Cingular. Management believes that consolidation is critical and indicated that a transaction with AT&T Wireless appears to make the most sense. The main obstacles to a transaction are valuation and social/governance issues.
- \*\*\* Rated Outperform. Target price: \$32.

	GAAP Estimates			P/E		
	Q1 Mar	Q2 Jun	Q3 Sep	Q4 Dec	Year	Year
2001	\$0.51A	\$0.61A	\$0.59A	\$0.64A	\$2.34A	10.6x
2002	\$0.51A	\$0.61A	\$0.56E	\$0.59E	\$2.26E	11.0x
2003					\$2.36E	10.5x

<sup>\*\*</sup>PLEASE REFER TO THE LAST PAGE OF THIS REPORT FOR IMPORTANT DISCLOSURE INFORMATION

#### **Management Meeting Summary**

The Company Expects Access Line Losses in California to Accelerate Due to Low UNE Prices and Delayed Long Distance Entry. SBC indicated that competition intensified in California after UNE rates were lowered in May. SBC expects to file a cost docket with the California PUC (CPUC) in hopes of raising UNE rates to what SBC believes is a cost-based rate. Management hopes that the CPUC would rule on the docket by year end. Management believes that competition will stabilize in California in 2003 if SBC receives a positive ruling on the rate case, and as the company gains long distance relief and begins offering a bundled product. The CPUC is now expected to vote on SBC's 271 application on September 19 and SBC would file with the FCC shortly thereafter. This would imply a late December/early January FCC ruling. SBC's current 2002 EPS guidance assumes no benefit from California long distance entry.

Intensifying Competition in the Ameritech Region Will Likely Continue Well Into 2003. Management cited high retail rates and low UNE rates as the key reasons for continued line losses in the region. The company estimates that UNE-P pricing in key Ameritech states is in the \$14-\$15 range, a rate that management contends is far below actual cost. According to management, approximately 70% of SBC's UNE-P growth and access line losses are in the Ameritech region. SBC does not expect to gain entry into key long distance markets in the Ameritech region until mid-2003, further exacerbating the situation.

<sup>\*\*\*</sup>Bear Stearns acted as a financial advisor to AOLTime Warner Inc. in its pending transaction with AT&T Corp. & Comcast Corp. involving the restructuring of Time Warner Entertainment.

#### Competitive Forces May Have Stabilized in the Southwestern Bell Region.

Competitive penetration of the region's local market has flattened in the 15%-20% range. SBC partly attributes the stabilization to its ability to offer long distance service as part of a bundle in all Southwestern Bell states. Also, management cited reasonably-priced UNE rates (in the \$20 range). In contrast to California and the Ameritech region, SBC indicated that consumer revenue in the Southwestern Bell states actually increased 3% last quarter.

Economic Weakness is the Primary Cause of Business Access Line Losses. In contrast, management estimates that 78% of retail consumer access line loss is due to UNE-P with the balance due to the economy (less than 10%) and technology substitution.

SBC's Local Data Business Continues to Grow. Within local data, the high-end of the market is down about 5%, the government and SME markets are up in the double-digits, wholesale data is up 9%, but ISP business is down approximately 44%. Local data trends have not changed much since the end of 2Q02, according to management.

SBC is Pursuing an Organic Strategy to Attack the Enterprise Market ... For Now. Management believes that the company is 18 months away from having a meaningful enterprise product set and five years away from gaining significant market share. Management discussed possible acquisition targets to expedite market entry. Qwest, Broadwing, and WorldCom were deemed less attractive acquisition candidates. Sprint FON was identified as an attractive property but a relatively small customer base was noted. AT&T seemed to be the most attractive candidate to SBC, but the company cited DoJ hurdles in completing any deal. Specifically, SBC believes that it might have to divest AT&T Consumer customers in-region. In addition, AT&T's CLEC business and its small and medium-sized business customers could create problems with DoJ approval. SBC indicated that finding a buyer for those assets would be a challenge. Management believes that over time, margins in the large enterprise market will improve and pricing across most enterprise business products will be stable or increase.

No Anticipation of a Price War in Consumer Long Distance. SBC indicated (and we have observed) that RBOC pricing is in-line or higher than the IXCs'. Management believes that its ARPU and MOU will be relatively stable as the company penetrates markets where it has section 271 relief. SBC assumes that it can achieve 30% market share 12 months after entering a new market and is targeting a long run (3-4 years) penetration rate in the 60%-70% range.

Although Elusive, Wireless Consolidation Remains a Serious Consideration. Management identified spectrum depth and holes in its footprint as the key constraints for Cingular Wireless. The eventual rollout of national wireless data products exacerbate these concerns. SBC also identified duplicative capital investment as a key reason for consolidation. Management identified AT&T Wireless as a potential candidate, but cited valuation, governance, and other social issues as potential hurdles. VoiceStream was also mentioned, but valuation seems to be a stumbling block for now.

#### Other Notable Information:

excluding WorldCom, bad debt rates have been stable

WorldCom receivable is fully reserved; may see increased levels of bad debt associated with WorldCom due to approximately \$200M of monthly products and services sales; expect cash payments from WorldCom to commence this week excess cash, including any cash associated with BCE's potential purchase of SBC's remaining 16% ownership in BCE (allowable from 10/15/02-11/15/02), will be used to reduce debt pension income erosion will have a significant impact on future earnings

Our Price Target is \$32. We base our objective on a P/E of 13.9x estimated 2002 EPS (a 25% discount to the market multiple). Our target reflects a 6.5x multiple of our estimate of SBC's proportional share of Cingular's 2002 EBITDA (in line with current market value for national wireless service providers), a 6.5x multiple on 2002E directory EBITDA, and a 5.5x EBITDA multiple on the core wireline unit.

Valuation Method For Target Price: Valuation is based on a 25% discount to the S&P 500 P/E multiple.

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Ratings for Stocks (vs. analyst coverage universe):

Outperform (O) - Stock is projected to outperform analyst's industry coverage universe over the next 12 months.

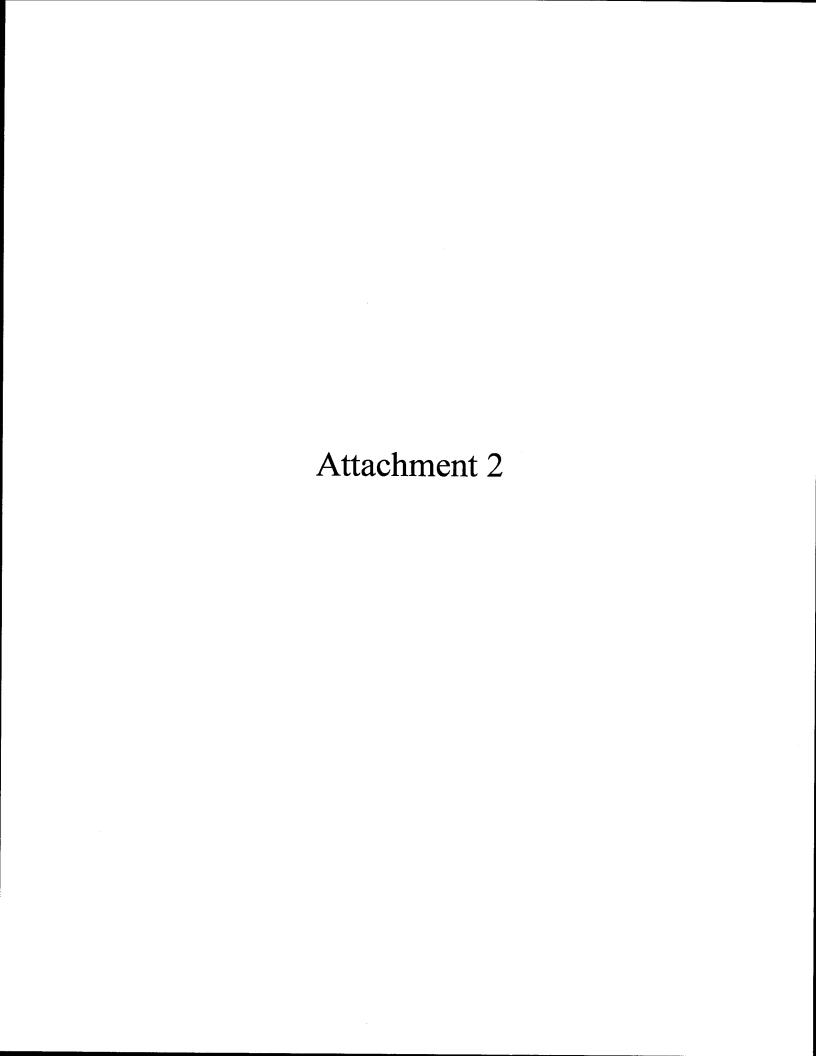
Peer Perform (P) - Stock is projected to perform approximately in line with analyst's industry coverage universe over the next 12 months. Underperform (U) - Stock is projected to underperform analyst's industry coverage universe over the next 12 months.

Ratings for Sectors (vs. regional broader market index):

Market Overweight (MO) - Expect the industry to perform better than the primary market index for the region over the next 12 months. Market Weight (MW) - Expect the industry to perform approximately in line with the primary market index for the region over the next 12 months.

Market Underweight (MU) - Expect the industry to underperform the primary market index for the region over the next 12 months.

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# REGULATORY AUDIT OF PACIFIC BELL FOR THE YEARS 1997, 1998 AND 1999

Prepared for:

# California Public Utilities Commission

# VOLUME 1:

**Executive Summary** 

Audit Background, Scope, Objectives and Recommendations

CPUC Financial Reporting and Regulated Intrastate Earnings

By:

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February 21, 2002

Version for Public Reirase - Reflects Deletion of Information Pacific Bell Asserts To Be Confidential. Deleted Information May Be Released at a Future Date Upon Ruling By the California Public Utilities Commission or the Assigned Administrative Law Judge.

#### OVERLAND CONSULTING

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February 21, 2002

Mr. Jack Leutza
Director - Telecommunications Division
California Public Utilities Commission
505 Van Ness Av.
San Francisco, CA 94102

Dear Mr. Leutza,

The attached report describes the results of Overland Consulting's regulatory audit of Pacific Bell performed in accordance with the requirements set forth in California Public Utilities Commission (CPUC) Decision 96-05-03, and reflected in contract PS-985044, which was approved by the CPUC and dated June 21, 1999.

The scope of the audit included a review of Pacific Bell's affiliate transactions, procedures for allocating costs between regulated and non-regulated activities, regulatory financial reporting and monitoring reports. The audit period included the years 1997, 1998 and 1999. Audit objectives included determining compliance with CPUC accounting policies, affiliate transaction rules and cost allocations; assessing internal accounting and administrative control with respect to CPUC requirements; adjusting regulated intrastate operating income reported by Pacific Bell to correct errors and non-compliance with CPUC requirements; assessing the potential for cross-subsidies and anti-competitive behavior with respect to affiliate transactions; and determining Pacific Bell's compliance with the CPUC's New Regulatory Framework (NRF) monitoring requirements. To the extent the data and information Pacific Bell provided enabled us to do so, we conducted our audit in accordance with Generally Accepted Auditing Standards applicable to the regulatory audit ordered by the Commission in Decision 96-05-036. The audit was not designed to develop an opinion concerning financial statements Pacific Bell or its parent, SBC Communications, Inc., filed with the Securities and Exchange Commission or in annual reports to shareholders.

The audit disclosed areas in which Pacific Bell did not comply with the CPUC's accounting, non-regulated allocation and affiliate transaction requirements. We also found areas in which Pacific Bell did not comply with the CPUC's NRF monitoring requirements. The audit disclosed certain weaknesses in Pacific Bell's internal controls as they relate to CPUC requirements. Our audit report includes recommendations to correct compliance errors and internal control weaknesses, and recommendations to improve the quality of reporting to the CPUC.

Mr. Jack Leutza Page two

Pacific Bell prepares and submits an Intrastate Earnings Monitoring Report (IEMR). The IEMR is intended to show regulated intrastate net operating income calculated in accordance with CPUC accounting and ratemaking rules. The IEMR is a regulatory report and is not a financial statement subject to annual audit. To the extent our audit identified instances of non-compliance with CPUC requirements that affected the calculation of regulated intrastate operating income, we calculated adjustments to the revenues, expenses and rate base that Pacific Bell reported on its IEMR. In making adjustments we were required to interpret existing CPUC rules and administrative precedents as they applied to Pacific Bell's IEMR results. Based on our audit, we believe the regulated intrastate net operating income Pacific Bell reported in audit period IEMRs was substantially understated.

The IEMR results filed by Pacific Bell did not show sufficient earnings to trigger customer sharing under the NRF. After our recommended audit adjustments, regulated intrastate net operating income was substantially higher than Pacific Bell reported to the CPUC in all three years of the audit period. Audit-adjusted IEMRs show that earnings sharing was triggered in 1997 and 1998. Had sharing not been suspended beginning in 1999, sharing would also have been triggered in 1999.

In attempting to meet audit objectives, we were constrained by limits on access to relevant information. Pacific Bell controlled our audit efforts within an adversarial litigation framework. Although litigation procedures often apply in regulatory audits, audits subjected to litigation restrictions cannot be relied upon to provide full disclosure of relevant information. Certain data and information we requested and believe to be relevant was not provided and certain data requests remained unanswered at the conclusion of the audit. Provision of this information could result in additional findings, identification of additional areas of regulatory concern, and additional audit adjustments to IEMR results.

The accompanying report was prepared for the CPUC to document Pacific Bell's compliance with CPUC requirements and related internal controls, to identify issues of regulatory concern in specified areas, and to develop recommendations for the CPUC. It is not intended to be used for any other purpose. The report contains information that Pacific Bell and its affiliates may consider to be proprietary and confidential. Until confidentiality issues concerning the report are settled, its distribution should be limited to individuals who are covered by CPUC confidentiality policies or have entered into appropriate non-disclosure agreements with Pacific Bell.

Sincerely.

Howard Lubow,

President, Overland Consulting

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# **Chapter 1 - Executive Summary**

# I. Introduction

In 1989 the California Public Utilities Commission (Commission or CPUC) adopted an incentive-based regulatory framework for Pacific Bell and Verizon California (at the time GTE California, Inc.). The New Regulatory Framework (NRF) incorporated financial incentives, streamlined regulation and safeguards for customers and shareholders. The Commission established a set of regulatory goals and linked the success of the NRF to its ability to obtain information of sufficient quality and depth to determine whether the goals were met. The Commission adopted a monitoring program intended to provide specific utility data and reports to assess progress in meeting its NRF regulatory goals.

This report documents the results of a regulatory audit of Pacific Bell performed by Overland Consulting. The audit was performed for the Commission under the supervision of the Telecommunications Division (TD). The audit covered calendar years 1997 through 1999 and included reviews of Pacific Bell's compliance with CPUC accounting requirements, procedures to allocate costs between regulated and non-regulated activities, policies and rules for pricing transactions between Pacific Bell and its affiliated companies and NRF monitoring reports. This audit report focuses on Commission-prescribed regulatory accounting and is not intended to express any opinion on financial statements that Pacific Bell or its parent, SBC Communications, Inc. (SBC), filed with the Securities and Exchange Commission (SEC) or in annual shareholder reports.

# II. Overview of Audit Findings and Conclusions

The audit of financial results identified 67 corrections to Pacific Bell's regulated operating revenues, expenses and rate base. Audit corrections to bring financial results into compliance with CPUC requirements increased the regulated intrastate net operating income that Pacific Bell reported during the audit period by \$1.94 billion. This translates into recommended customer refunds under NRF earnings sharing rules of \$349 million for the years 1997 and 1998. NRF earnings sharing rules were suspended by the CPUC effective in 1999. Customer refunds for 1999 would have totaled \$457 million if the sharing rules had been effective. Following are additional key findings and conclusions from the audit.

### **Understatement of Regulated Earnings**

- Pacific Bell did not comply with CPUC accounting requirements in reporting regulated financial results to the CPUC. Most significantly, Pacific Bell did not account for pension expense, other post retirement benefits expense, depreciation expense or income tax expense in compliance with CPUC regulatory requirements.
- Because Pacific Bell did not comply with CPUC accounting requirements, regulated net operating income reported to the CPUC was substantially understated in each of the three audited years. As a result of understated regulated net operating income, earnings owed to customers under NRF sharing rules were not reported or refunded.

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# **Issues Raised by Affiliate Relationships**

- •• Pacific Bell's recent transfer of telephone company functions, assets and employees to corporate shared services affiliates controlled by SBC has the potential to significantly reduce the CPUC's control and authority in regulating telephone operations and accounting.
- Pacific Bell and its affiliates did not always comply with CPUC affiliate transactions rules. Internal control over certain affiliate transactions was inadequate.
- •• Pacific Bell and its affiliates were unable or unwilling to provide sufficient support for some affiliate transactions, including adequate cost support for affiliate transfer pricing and certain costs allocated by shared services affiliates. Pacific Bell did not answer questions regarding its policies for transferring telephone company customer information to affiliates.

## The NRF Monitoring Program

•• NRF monitoring program reports filed by Pacific Bell did not provide sufficient information to enable the CPUC to determine whether it was meeting its NRF goals.

### A. Summary of Intrastate Financial Results

The table below summarizes intrastate financial results prepared for the CPUC and customer-refundable earnings as reported by Pacific Bell and as determined by the audit.

Table 1-1			
Pacific Bell's CPUC-Basis Financial Results		er Refunds	
Reported By Pacific Bell and A	udit-Adjusted		
Source: Pacific Bell Financial Reports and Audit workpapers			
	Reported By Pacific Bell	Audit-Adjusted	
1997			
Net Regulated Intrastate Operating Income	652,499,328	1,114,302,393	
Return on Regulated Intrastate Rate Base	6.49%	11.72%	
Customer Refunds Under NRF Sharing Provisions	0	17,638,716	
1998			
Net Regulated Intrastate Operating Income	922,472,419	1,549,326,224	
Return on Regulated Intrastate Rate Base	9.07%	15.86%	
Customer Refunds Under NRF Sharing Provisions	0	331,184,800	
1999	Î		
Net Regulated Intrastate Operating Income	962,198,083	1,817,964,464	
Return on Intrastate Regulated Rate Base	9.66%	18.22%	
Customer Refunds Under NRF Sharing Provisions (1)	0	457,244,588	
Audit Period Combined			
Net Regulated Operating Income	2,537,169,830	4,481,593,081	
1. Audit-adjusted amount is pro forma. The CPUC suspend	led customer sharing	effective in 1999.	

Intrastate financial results prepared for the CPUC were the product of an overly complicated and poorly disclosed process involving the adjustment of FCC-basis financial data. The subsidiaries included in intrastate results Pacific Bell reported to the CPUC varied from year to year. Pro-forma financial information necessary to make the results comparable between years was not presented. There was insufficient disclosure of the amounts and basis for differences between FCC and CPUC financial results. CPUC-basis financial reporting adjustments and many ratemaking adjustments were bundled together on Pacific Bell's Intrastate Earnings Monitoring Reports (IEMRs) and were not separately identified or explained in materials filed with the CPUC.<sup>1</sup>

# B. Affiliate Transactions

Pacific Bell's regulated telephone company functions, employees and proprietary information are being transferred to corporate "shared services" affiliates. Several thousand telco employees were transferred at the end of 1999 alone. The transfer of functions out of the telephone company has the potential to significantly reduce the control and authority the CPUC has traditionally exercised over regulated telephone operations. Evidence for this can be seen in Pacific Bell's resistance to auditing affiliate transactions, in the fact that the functions transferred to affiliates are no longer accounted for under FCC Part 32 accounting rules, in the lack of sufficient affiliate organizational documentation, and in the accounting complexities introduced by affiliate transactions that make them harder to track and evaluate than transactions incurred within Pacific Bell.

Internal accounting controls governing certain affiliate transactions processes were inadequate. Pacific Bell and SBC did not always comply with CPUC requirements governing affiliate transactions and could not adequately support certain affiliate transaction components, such as the cost basis for pricing transactions between Pacific Bell and its affiliates. The structure of SBC's affiliate organizations maintained for regulatory accounting purposes was undocumented and details about the activities and functions that constituted inter-company billing affiliates were sometimes poorly understood even by employees that Pacific Bell represented to be subject matter experts. Given the growing magnitude of affiliate transactions, unless control weaknesses and compliance problems are corrected they may materially affect the regulated operating income Pacific Bell reports to the CPUC in the years after the audit period. Audit corrections to affiliate transactions recorded in Pacific Bell's Intrastate Earnings Monitoring Reports increased regulated audit period intrastate net operating income by \$97 million.

## C. Cost Allocations Between Regulated and Non-Regulated Activities

A majority of the FCC procedures for allocating telephone company costs between regulated and non-regulated accounting categories were well controlled. However, we found certain allocation procedures were inconsistent with attributable cost principles adopted in FCC and CPUC rules and increasing levels of affiliate transactions has weakened Pacific Bell's compliance with Part 64 regulated / non-regulated cost allocation rules. Audit corrections to recorded Part 64 cost allocations increased audit period regulated intrastate net operating income by \$44 million.

<sup>&</sup>lt;sup>1</sup>The IEMR is a regulatory report intended to show regulated intrastate net operating income calculated in accordance with CPUC accounting and ratemaking rules. Its results are not subject to annual audit.

# D. NRF Monitoring Program

The NRF monitoring program, last revised in 1992, does not provide sufficient information to enable the CPUC to determine whether it is meeting its NRF goals. Specific deficiencies include data to assess competition, service quality and customer satisfaction, technological advancement and intrastate regulated earnings.

# E. <u>Difficulties Encountered in Completing the Audit</u>

The audit required approximately 18 months to complete, six months longer than originally scheduled. We met most, but not all, audit objectives. Impediments to successfully completing the audit within the time originally scheduled included restrictions that Pacific Bell imposed on the data it considered to be relevant and within the audit scope, data request response times that averaged more than two months and sometimes extended for many months, and, notwithstanding objections to requests based on scope or relevance, Pacific Bell's inability or unwillingness to provide certain information and data.

We attempted to perform the audit in accordance with Generally Accepted Auditing Standards (GAAS) applicable to a regulatory audit. GAAS requires that auditors obtain sufficient competent evidential matter to provide a basis for findings and conclusions. The restrictions imposed on the audit prevented us from obtaining sufficient data to develop conclusions in some areas. To the extent that available time and Pacific Bell's responses to outstanding data requests permit us to complete our analysis and develop conclusions in these areas, we will supplement our report. Completing these areas will not affect our conclusion that regulated income was significantly understated during the audit period; however, it may result in a change in the calculated amount of NRF refunds owed to customers.

# III. Discussion of Significant Audit Findings and Issues

# A. Regulated Operating Revenue, Expense and Rate Base (Chapters 4 - 11)

Combined audit period corrections to amounts recorded directly in regulated accounts increased audit period (1997 to 1999) intrastate regulated operating income by \$1.8 billion and decreased average intrastate regulated rate base by \$314 million. Four corrections account for 75 percent of the change in intrastate operating income. These corrections address 1) depreciation reserve deficiency amortization; 2) pension costs; 3) other post-retirement benefits costs; and 4) income tax accounting policy.

# 1. Reserve Deficiency Amortization Adjustment

Pacific Bell increased its intrastate regulated depreciation expense by \$612 million in 1999 to reflect "reserve deficiency amortization." The increase reflects the amortization, over a six year period, of the intrastate portion of a plant write-down Pacific Bell recorded for external financial reporting purposes in 1995. By 1999, the assumptions underlying the 1995 plant write-down had been proven to be highly inaccurate. In spite of this, Pacific Bell chose to amortize the reserve deficiency on the CPUC books, causing a significant reduction in the earnings reported the 1999 IEMR. The reserve deficiency

<sup>&</sup>lt;sup>2</sup>A plant write down is the removal of plant from the books. Essentially, it is an acceleration of future years' depreciation expenses into the current period.

<sup>&</sup>lt;sup>3</sup>Because it takes place over six years, the reserve deficiency amortization determined by Pacific Bell will continue to significantly reduce reported IEMR earnings through 2004.

amortization was not implemented pursuant to accounting requirements; rather, it was implemented at management's discretion to achieve regulatory objectives. The six-year amortization period was arbitrary and also based on management's regulatory objectives, rather than accounting principles.

The reserve deficiency amortization is not an allowable cost for ratemaking purposes because it does not reflect a real increase in the cost of providing utility service. Pacific Bell did not request CPUC approval for the reserve deficiency amortization and has not made any showing that the reserve deficiency amortization would be allowed for ratemaking purposes. Therefore, we removed Pacific Bell's reserve deficiency amortization in calculating audit-adjusted regulated operating expense.

### 2. Pension Costs

Intrastate regulated pension expenses reported to the CPUC were overstated by \$357 million during the audit period as a result of Pacific Bell's failure to correctly apply CPUC pension cost accounting requirements. As set forth in Decision 88-03-072, the CPUC requires the use of the Aggregate Cost Method (ACM) to determine pension costs. Essentially, ACM pension cost is the difference between the present value of pension benefit payments owed and funded pension assets attributable to the current year. The amount attributable to the current year is calculated by spreading the total difference over the average remaining employment period for active plan participants. Because Pacific Bell's pension plan is significantly overfunded (i.e. funded pension assets significantly exceed forecasted benefit payments), proper application of the ACM produces *negative* intrastate regulated pension expense of \$357 million during the audit period. Pacific Bell did not use the ACM to determine its pension costs during the audit period. Instead, Pacific Bell arbitrarily set its intrastate pension costs equal to zero in all three years. This caused an overstatement of pension expense under CPUC accounting requirements.

Under Generally Accepted Accounting Principles (GAAP), pension costs are determined in accordance with Statement of Financial Accounting Standards (SFAS) 87. GAAP calculations of pension cost, which are different from the costs calculated for CPUC purposes, are used for Pacific Bell's FCC and SEC (external) financial reporting. Over time, pension costs calculated under GAAP have been lower than the pension costs Pacific Bell has been permitted to recover for CPUC purposes. Pacific Bell maintains a regulatory liability account to track the intrastate portion of the difference between its GAAP and CPUC pension costs. The December 31, 1999 balance of \$1.1 billion in this account represents the cumulative amount by which the pension costs Pacific Bell recognized for CPUC purposes exceeded pension costs recognized under GAAP. Pacific Bell's decision to set pension costs equal to zero when the ACM produces negative expense has contributed to a large and growing disparity between GAAP and CPUC pension costs. The audit correction, designed to bring CPUC pension expense into compliance with CPUC accounting requirements, will slow the growth of the disparity.

#### 3. Other Post-Retirement Benefit Costs

Pacific Bell provides post-retirement benefits other than pensions (PBOPs) to retired employees. The PBOPs consist of post-retirement medical, dental and life insurance benefits and discounts on telephone service. Medical and dental benefits account for 85% of Pacific Bell's PBOP liability.

The CPUC's PBOP policy limits annual PBOP costs to the amount of tax-deductible contributions made to external trust funds established to pay PBOP benefits. Pacific Bell contributed \$444 million to its PBOP external trusts during the audit period, on an intrastate regulated operations basis. Therefore, under the CPUC's PBOP policy, Pacific Bell's maximum allowable PBOP expense was \$444 million. Pacific Bell claimed \$972 million in PBOP intrastate regulated expenses on its IEMR reports for the audit period. The

PBOP operating expenses claimed by Pacific Bell exceeded the maximum amount permitted under the CPUC's PBOP policy by \$528 million.

The \$528 million of PBOP expense improperly claimed by Pacific Bell largely reflects the accelerated recognition of costs for employees terminated in a 1993 force reduction program. Pacific Bell recognized the accelerated costs in 1993 when it announced the force reduction program and deferred the costs as a regulatory asset. Pacific Bell increased the PBOP costs claimed on its 1998 IEMR by \$400 million to reflect the immediate write-off of that regulatory asset. The CPUC's PBOP accounting policies do not permit accelerated recognition of PBOP costs for terminated employees. Under the CPUC's policy, PBOP costs associated with terminated employees are recognized when the contributions needed to pay their PBOP benefits are actually made to the PBOP external trusts. Limiting Pacific Bell's PBOP costs to the amount permitted by the CPUC's PBOP policy (i.e. the amount actually funded during the audit period) will not deny Pacific Bell an opportunity to fully recognize its reasonable PBOP costs over the appropriate funding period.

Pacific Bell withdrew \$98 million from its management pension plan trust fund in December 1999. In the same month, Pacific Bell withdrew \$180 million from its PBOP life insurance trust. The withdrawals violated the CPUC's policies concerning the use of pension and PBOP trust fund assets. The pension and PBOP trust fund withdrawals potentially impact the amount of PBOP costs reportable under CPUC accounting requirements in 1999. The proper accounting and ratemaking treatment for those transactions will be determined after Pacific Bell responds to outstanding data requests.

## 4. CPUC Regulated Income Tax Expense

The CPUC has a long-standing policy of requiring flow-through accounting treatment for temporary differences between book and taxable income to the extent permitted by federal income tax regulations.<sup>4</sup> Under the flow-through accounting method, income tax expense reported for regulatory financial results reflects the actual taxes paid to the government for the current year. Pacific Bell provided flow-through accounting treatment to some temporary differences during the audit period. However, Pacific Bell provided tax normalization treatment to many temporary differences that should have been accounted for on a flow-through basis. After considering the impact of other audit corrections on temporary difference amounts, the proper application of the CPUC's flow-through policy reduces audit period intrastate regulated deferred income taxes by \$438 million compared to the level produced by Pacific Bell's income tax normalization policy. Temporary differences attributable to pension expense and the California universal service fund account for 86 percent of that amount. Therefore, from the standpoint of audit period regulated operating income, the key income tax accounting issue is whether the pension and universal service fund temporary differences should be accounted for on a flow-through or a normalization basis.

The proper application of the aggregate cost method to determine CPUC pension expenses results in negative intrastate regulated pension expense of \$357 million during the audit period. Negative pension expense increases book income but does not increase taxable income. Under the normalization method, book income tax expense is set as if the negative pension expense was taxable income. The flow-through method results in lower tax expense than the normalization method in years in which pension

<sup>&</sup>lt;sup>4</sup> Temporary differences reflect differences in the timing of the recognition of revenues and expenses for financial reporting and income tax return purposes. Temporary differences are caused by differences between financial reporting accounting policies and the tax requirements for determining taxable income. Because the same expenses and revenues are ultimately recognized on the financial statements and the tax returns over time, the differences eventually reverse and are therefore called temporary differences.

expense is negative because negative pension expense does not increase the amount of taxes owed to the government for the current tax year. Under the CPUC's flow-through policy, the pension temporary difference should be accounted for on a flow-through basis.

The universal service fund temporary difference is a new temporary difference resulting from the implementation of the California High Cost Fund-B. For income tax purposes, the payments received from the fund are treated as a reduction of construction costs because the payments are made to subsidize the provision of service requiring plant investment in high cost (rural) areas. As a result, the fund payments are taxed over the lives of associated assets (as smaller depreciation expense deductions due to the reduction of plant costs), rather than in the year of receipt. For financial reporting to the CPUC, Pacific Bell included the money it received from the fund as operating revenue and normalized the temporary difference in revenue recognition on its CPUC-basis books. Under the CPUC's income tax expense accounting policy the universal service fund temporary difference should be accounted for on a flow-through basis. Income tax expense for IEMR purposes should be based on the tax law, which recognizes the high-cost fund revenue over the life of the assets it subsidizes.

## 5. Operating Revenues and Expenses

Our review resulted in four audit corrections to Pacific Bell's 1997 regulated operating revenues and other operating income. These include 1) eliminating unsupported and unauditable accruals for regulatory contingent liabilities; 2) correcting a posting error related to Bellcore dividends; 3) removing uncollectible revenues recorded in 1997 but attributable to 1996 operations; and 4) increasing other operating income to reflect the ratepayer's portion of the pre-tax gain on the sale of Bellcore. We did not identify any corrections to Pacific Bell's 1998 and 1999 revenues. The four corrections increased Pacific Bell's 1997 intrastate regulated revenues by \$116 million.

We identified and calculated nine audit corrections to operating expenses. These include 1) removing \$138 million in local number portability (LNP) costs from intrastate operating expenses that the FCC explicitly ruled should be assigned directly to the interstate jurisdiction; 2) removing \$49 million in local competition implementation costs that should have been deferred and amortized over the period of CPUC-authorized surcharge recovery that began in 2001; 3) reducing operating expense by \$35 million to reflect the allocation of merger savings between ratepayers and shareholders ordered in the CPUC decision that approved the merger of SBC and Pacific Telesis; 4) removing \$41 million in cost associated with the shut down of an Advanced Communications Network that was never placed into service; 5) reducing operating expenses by \$44 million to correct Pacific Bell's accounting for a December 1999 software buy-out agreement; 6) removing \$103 million of unsupported and unauditable litigation and regulatory accruals from operating expense; 7) reducing incentive compensation accruals by \$29 million to reflect the actual payout levels for the 1997, 1998 and 1999 performance years; 8) reducing 1997 and 1998 operating expense by \$42 million to remove the cost of settlements paid to contract billing customers for an increase in uncollectible amounts attributable to 1996 operations; and 9) increasing operating expense by \$19 million to correct the classification of traffic bound for internet service providers for separations purposes. In total these nine corrections reduce audit period intrastate regulated operating expense by \$463 million.

In addition to the reserve deficiency adjustment discussed above, we made a correction to eliminate the impact of an accounting error associated with depreciation expense. The formula used to calculate the jurisdictional adjustment for intra-building cable amortization contained an error that resulted in a \$61 million overstatement of 1997 and 1998 intrastate depreciation expense. We corrected this error.

# 6. Rate Base

We made five corrections to net plant that increased average audit period intrastate net plant by \$34 million. A sixth correction involving Allowance for Funds Used During Construction (AFUDC) could not be quantified because the necessary information had not been provided at the time of this report. Overland identified numerous errors in Pacific Bell's cash working capital lead-lag studies. The errors imply significant deficiencies in Pacific Bell's internal controls over the preparation of cash working capital studies. Cash working capital is impacted by other audit corrections to revenues and expenses. After considering these other audit corrections, Pacific Bell's corrected intrastate regulated cash working capital requirement averaged \$149 million during the audit period, \$324 million lower than the average amount claimed by Pacific Bell.

# B. Affiliate Transactions (Chapters 12 - 19)

Combined audit period corrections to affiliate transactions recorded in Pacific Bell's IEMR increased audit period regulated intrastate net operating income by \$97 million. This discussion presents summarized findings and conclusions for our audit of Pacific Bell's affiliate transactions. It is divided into the following subjects:

- Internal Accounting Controls
- CPUC Regulatory Authority and Control
- Pacific Bell's Management Control
- Compliance with FCC and CPUC Affiliate Transaction Requirements
- Issues Affecting Markets and Competition
- Cross Subsidization
- Affiliate Transaction Audit Adjustments

# 1. Internal Accounting Controls

SBC and Pacific Bell had accounting systems in place during the audit period to identify and bill affiliate services in all of the areas we reviewed. However, we found a number of control weaknesses in these systems. Internal accounting controls were weakest with respect to the new shared services affiliates, SBC Services and SBC Operations. We did not conclude that internal control weaknesses affecting affiliate service transactions had a material impact on Pacific Bell's financial results reported to the CPUC during the years 1997 through 1999. In part, this is because the level of transactions between Pacific Bell and affiliates, although growing at a rapid rate, was relatively small for most of the audit period. Significant transfers of telephone company assets to shared services affiliates, although pending, did not take place during the audit period. We were unable to evaluate the impact of transactions involving intellectual property and proprietary information because we did not have the time or the resources to effectively audit these areas and because Pacific Bell would not answer certain data requests.

2000 was a watershed year for Pacific Bell's affiliate relationships. There was significant movement of employees from the telephone company to the unregulated shared services affiliates at the end of 1999 and "advanced services", a significant component of the Pacific Bell's evolving telecommunications

**Overland Consulting** 

<sup>&</sup>lt;sup>5</sup> Allowance for Funds Used During Construction includes the financing (interest) cost of funds employed to construct plant. It is usually calculated using the company's overall average interest rate on debt.

business, was transferred from Pacific Bell to SBC Advanced Solutions, Inc. (ASI).<sup>6</sup> The absolute value of reported income statement transactions between Pacific Bell and affiliates doubled between 1999 to 2000, from \$1.3 billion to \$2.5 billion. By 2000, services provided by affiliates constituted more than 25 percent of Pacific Bell's regulated operating expenses. SBC Services, which did not have sufficient accounting controls established during the audit period, increased its billings to Pacific Bell more than 30 fold in 2000, to \$1.1 billion. It is reasonable to conclude that unless internal accounting controls improved, the impact of control weaknesses could have a growing and potentially significant impact on Pacific Bell's intrastate financial results in the years after 1999.

# 2. CPUC Regulatory Control

Because the affiliates to which Pacific Bell's functions are being transferred are unregulated and managed from the corporate level, the possibility exists that the CPUC could lose some or much of its ability to regulate traditional telephone operations. The Commission should consider the potential loss of authority to set accounting and operating standards and reporting requirements as a consequence of transferring functions out of the regulated telephone company. Pacific Bell's resistance to a review of its affiliate transactions is on the record at the CPUC and was evident to us during the audit. Prior to the audit Pacific Bell argued that affiliate transactions were not a legitimate component of an audit performed under California Public Utilities Code Section 314.5. At one point during the audit, Pacific Bell declared a moratorium on affiliate transaction data requests and requested that affiliate information already provided be returned. SBC and Pacific Bell would not or could not provide the information necessary to complete an audit of some affiliate issue areas.

Accounting procedures are also a concern as affiliate transactions grow. The corporate shared services affiliates to which telephone company functions are being transferred do not use the FCC's Part 32 Uniform System of Accounts. Certain cost information required by the CPUC is lost from Pacific Bell's general ledger when activities are transferred to affiliates and costs are incurred as inter-company charges. In most respects, affiliate transactions were more difficult to audit than transactions incurred within Pacific Bell.

Pacific Bell could not produce documentation describing SBC's organizational structure as it existed for inter-company billing purposes. It took months to acquire a database of SBC employees and weeks more to piece together the database codes that described the individual components of the organizations billed to Pacific Bell. An understanding of the components and activities of an affiliate's organization is an absolute requirement to effectively audit the amounts billed to the telephone company. The lack of adequate affiliate organizational documentation is a notable internal control weakness.

# 3. Pacific Bell's Management Control

Pacific Bell's and PTG's management control of Pacific Bell's operations declined after the merger with SBC. Strategic decision making by PTG's corporate management, whose primary focus was Pacific Bell, was ceded to SBC executives in Texas after the merger. Shared services affiliates were established to run Pacific Bell's marketing, network, and general and administrative functions from a corporate perspective. Pacific Bell's internal management control continued to decline after the audit period as several thousand employees and additional telco departments migrated to affiliates controlled by SBC.

<sup>&</sup>lt;sup>6</sup> Scope limitations precluded us from determining whether Pacific Bell was compensated for the value of the business transferred to ASI.

As management control of Pacific Bell shifts to SBC, Pacific Bell's unique interests become less significant in decision making. Corporate management's attention is naturally more focused on the interests of SBC as a whole. Although it is likely that consolidating telephone company functions into corporate shared services entities can produce economies of scope and scale for SBC, it is not at all certain that this will always have a positive impact on Pacific Bell. For example, after the SBC / PTG merger Pacific Bell's operating expenses increased because of a substantial increase in corporate charges. Pacific Bell's corporate charges increased from less than \$120 million in 1996, the year before the merger, to nearly \$300 million in 1999. Most of the increase was due to new and higher cost levels billed by SBC's Texas-based corporate organization, which was added to the California-based PTG organization that existed prior to the merger. Pacific Bell's corporate charges continued to climb in 2000. This occurred in part because cost allocations from Management Services Inc., SBC's Texas-based parent organization, were layered on top of costs being charged by PTG's parent organization prior to the merger.

## 4. Compliance with FCC and CPUC Affiliate Transaction Requirements

Pacific Bell billed non-regulated affiliates the CPUC-mandated 10 percent markup on affiliate services. It did not bill the mark up for services provided to other regulated telephone companies. Fully distributed cost calculations used to establish transfer prices for services Pacific Bell provided to affiliates were based on what appeared to be a flawed methodology. Pacific Bell charged the 25 percent-of-salary fee for transferred employees; however, it sometimes billed the parent for employees transferred to other affiliates. In 1997 the parent charged some employee transfer fees back to Pacific Bell. Pacific Bell failed to accrue inter-company revenue for a large employee transfer that occurred in December, 1999. Pacific Bell charged a CPUC-required fee to affiliates for sales referrals; however, the support Pacific Bell provided was insufficient to determine whether the fee was correctly calculated or applied to affiliate Although Pacific Bell would not answer our data requests on the subject, it is possible or likely that SBC Operations' outbound call centers used Pacific Bell's customer database to sell services to nonregulated affiliates. It does not appear that SBC Operations or the non-regulated affiliates on whose behalf it provided marketing paid the 13 percent sales referral fee. SBC Operations or another shared services affiliate may eventually do all of Pacific Bell's telemarketing. Although similar in substance to the affiliate marketing conducted by Pacific Bell, it does not appear that the CPUC has specifically ordered SBC Operations to collect and pay a referral fee when it uses Pacific Bell's customer database to sell services to non-regulated affiliates.

SBC and its subsidiaries did not always comply with affiliate transaction requirements. SBC was unable to provide FCC-mandated documentation supporting the allocation of employee time among subsidiaries. Pacific Bell recorded or attempted to record certain below-the-line parent company charges in above-the-line regulated accounts and in some cases affiliates did not supply Pacific Bell with sufficient information to properly direct affiliate charges to the correct accounts or the correct regulatory category (above or below-the-line). In some cases, the data available from the parent and shared services affiliates was insufficient to determine whether the charges to Pacific Bell were reasonable, consistent with FCC Part 64 attributable cost principles, or properly charged to customer (above-the-line), rather than shareholder (below-the-line), accounts. Most of our affiliate transaction audit adjustments related to improperly directed charges, and most misdirected charges were from the parent company. In some cases, affiliate employees did not properly track the nature of their costs; in others the costs were identifiable but Pacific Bell did not receive the information necessary to record the charges from the affiliate in the proper account.

# 5. Issues Affecting Markets and Competition

Because our audit was largely confined to transactions affecting Pacific Bell's accounts, it did not include an in-depth analysis of operations and business practices or the operational interaction between affiliates and Pacific Bell. As such, we did not determine whether competitive practices were reasonable. However, one of our audit objectives was to determine whether affiliate transaction procedures were sufficient to prevent anti-competitive behavior. In analyzing SBC's organization and the changes in affiliate structure, we identified several areas of concern. The most significant involved the transfer of telephone company marketing and network planning functions to SBC Operations and the transfer of "advanced services" to SBC Advanced Solutions Inc. (ASI).

## a. Joint Marketing and Use of Telephone Company Customer Data

The transfer of the marketing function to SBC Operations creates a probability, if not a certainty, that telephone company customer data will be made available to non-regulated affiliates for marketing purposes. This could confer a competitive advantage on Pacific Bell's non-regulated affiliates. To the extent customer data is currently being shared with non-regulated affiliates, it raises customer privacy concerns, particularly for customers with unlisted phone numbers. Pacific Bell did not respond to our requests concerning customer data sharing. We recommend the CPUC consider the competitive consequences of transferring customer data collected in a regulated monopoly environment to an unregulated corporate affiliate, and the implications that the use of customer data by unregulated affiliates has for customers' privacy rights.

#### b. Advanced Services

The transfer of Pacific Bell's advanced services (digital subscriber line, frame relay and cell relay services) to ASI was mandated by the FCC as a condition of the 1999 SBC / Ameritech merger. Because these services have better potential to become competitive than many local exchange services, the relationship between ASI and Pacific Bell has a direct bearing on whether the NRF goal of "opening telecommunications markets to competition" is met. The affiliate relationship created by the transfer produces a significant increase in the co-mingling of telephone company and affiliate activities and raises some important competitive and cross subsidy concerns. These include Pacific Bell's ownership of the network underlying advanced services that it does not control, the identification of Pacific Bell network components and activities indirectly supporting ASI's advanced services and the separation of these elements and activities from those charged to Pacific Bell's customers, the joint marketing of "advanced" telephone company services, and affiliate and competitor access to the network and Pacific Bell's operational support systems. Some of these issues are addressed in Appendix C of the FCC's SBC / Ameritech merger order. Audit scope limitations precluded us from reviewing the working relationship and transactions that have occurred between ASI and Pacific Bell since the advanced services transfer. We recommend the CPUC review the Pacific Bell / ASI relationship to determine whether concerns relating to competitive practices in California are properly addressed.

## c. Purchase and Control of Competitors

In September, 2000, SBC announced a \$150 million, 6 percent investment stake in Covad Communications, a company that describes itself as "the leading national broadband service provider of high-speed internet and network access utilizing Digital Subscriber Line technology." Covad is one

<sup>&</sup>lt;sup>7</sup> Covad Communications Press Release, December 13, 2001.

of SBC's local exchange competitors. In December, 2001, after Covad received court approval of a plan to emerge from bankruptcy, SBC and Covad closed on the planned funding.<sup>8</sup> The benefits of competition can be negated if potential competitors are simply purchased or otherwise controlled by the incumbent provider with which they are supposed to compete. The Commission should consider monitoring the ownership and management control relationships between SBC and other California local exchange companies so that it may take these relationships into account when evaluating the extent of local exchange competition in the state.

### 6. Cross-Subsidies

Notwithstanding the possibility that affiliates benefited from uncompensated use of Pacific Bell's customer database and other intellectual property and proprietary data (areas in which we were unable to complete our analysis), the audit period inter-affiliate cross subsidies we quantified were relatively minor. Examples included Pacific Bell being charged for SBC corporate acquisition investigation costs and for corporate executive awards for accomplishments unrelated to Pacific Bell.

We found other cross subsidies flowing from Pacific Bell's customers to SBC shareholders. Examples included parent company political and legislative influence costs and secondary cost allocations of parent company "management fees" charged to Pacific Bell's customer (above-the-line) accounts. We were unable to determine whether transfer-priced services provided by Pacific Bell and Southwestern Bell Telephone resulted in cross subsidies because support for the units of affiliate service was inadequate.

The potential for affiliate cross-subsidies increased significantly after the audit period with the planned transfer of several thousand telephone company employees to shared services affiliates and the transfer of advanced services to ASI. As marketing functions are transferred to SBC Operations, Pacific Bell will probably lose the revenue from fees Pacific Bell collects for sales referrals to non-regulated affiliates. In addition, it appears unlikely that SBC Operations is compensating Pacific Bell for the use of its customer database.

The transfer of advanced services to ASI represents a transfer of a business opportunity. When Pacific Bell made a similar transfer of its voice mail business to PBIS in 1992, the CPUC ordered PBIS to reimburse Pacific Bell for the going-concern value of the business transferred. To the extent Pacific Bell's regulated operations are not reimbursed for ADSL's development costs, Pacific Bell's regulated customers have cross-subsidized ASI by at least \$190 million. The precedent established in CPUC Decision 92-07-072, which addressed the transfer of Pacific Bell's Information Services Group to PBIS, suggests that ASI should reimburse Pacific Bell for the going-concern value of the advanced services transferred, an amount that could be significantly greater than audit period development costs.

Time and scope constraints prevented us from assessing the potential for cross-subsidies relating to the transfer of intellectual property and proprietary information. Although difficult to quantify for accounting purposes, SBC's reorganization of major telephone company marketing, network and administrative functions into corporate shared services subsidiaries creates a significant potential for affiliate cross subsidies in the form of uncompensated or under-compensated transfers of intellectual property, customer and network data, telco operating know how and trade secrets.

<sup>&</sup>lt;sup>8</sup> Covad Communications Press Release, December 20, 2001.

### 7. Audit Adjustments to Affiliate Transactions Recorded in Pacific Bell's Accounts

We adjusted affiliate transactions billed by and to Pacific Bell to bring the charges on Pacific Bell's books and audit period IEMRs into compliance with attributable cost principles and CPUC policy on regulated cost recovery. The majority of audit adjustments to expense involved costs that were either not attributable to Pacific Bell or were attributable to SBC shareholders, rather than Pacific Bell's regulated customers. Audit adjustments reduced affiliate amounts charged to Pacific Bell's intrastate regulated expenses by \$19.4 million, \$64.9 million and \$51.9 million in 1997, 1998 and 1999, respectively. An audit adjustment increased Pacific Bell's inter-company revenue by \$30.7 million in 1999. Audit adjustments to affiliate revenues and charges are discussed in detail Chapters 13 through 18.

## C. Regulated and Non-Regulated Cost Allocations (Chapter 20)

The majority of Pacific Bell's procedures for allocating cost between regulated and non-regulated activities were well controlled and consistent with CPUC requirements and FCC Part 64 attributable cost principles. The most significant control weakness in the overall process was Pacific Bell's failure to maintain the Profitability Information (PI) system required by the CPUC to allocate costs to specific services. It is unclear whether the service-specific embedded cost allocations produced by PI continue to serve a purpose. Notwithstanding this overall conclusion, we found a number of allocation procedures that were not consistent with attributable cost principles and we found costs that were incorrectly classified between regulated and non-regulated categories. In most cases in which Pacific Bell failed to employ procedures consistent with Part 64 cost allocation requirements, the result was an overstatement of above-the-line operating expense and an understatement of regulated earnings. Corrections to audit period cost allocations increased regulated intrastate net operating income by \$44 million.

# D. Pacific Bell's NRF Monitoring Program (Chapter 21)

The NRF monitoring program, last revised in 1992, does not provide sufficient relevant information to assist the Commission in meeting all of its NRF goals. Neither the program itself nor the content of existing reports have been modified to adapt to changes in the telecommunications industry. More than half of the total reports submitted during the audit period were service-specific "embedded cost" reports produced by a system (the Profitability Information system) that Pacific Bell no longer maintains. Some of the monitoring reports Pacific Bell filed bore only a tangential relationship to NRF regulatory goals. At the same time, data that appear critical to evaluating the success of NRF, including statistics to measure technological advancement and customer satisfaction, were sometimes lacking even though required by the monitoring program. Some reports appeared to be missing because Pacific Bell placed a strict, limiting interpretation on what it was required to file with the CPUC.

The CPUC identified "opening telecommunications markets to competition" as a regulatory goal. Statistics necessary to objectively evaluate the progress of competition in California are not available from the monitoring reports filed by Pacific Bell. A "Competitive Environment Report" Pacific Bell submitted as a monitoring report was a white paper advocating further deregulation of Pacific Bell. Monitoring reports in the area of technological advancement produced a small fraction of the information required in the May, 1992 NRF Monitoring Report Assessment. Pacific Bell failed to file the results of customer surveys it conducted during the audit period as required by the monitoring program. We requested, but did not receive, copies of the customer surveys Pacific Bell conducted during the audit period.

Financial reports filed in the monitoring program were obtuse and inadequate for the purpose of evaluating Pacific Bell's financial position and results in accordance with CPUC specific requirements. Some of the earnings adjustments Pacific Bell included in its audit period IEMRs were made to achieve regulatory objectives, rather than reflect the impact of CPUC rules and decisions on regulated earnings. As a result, absent an audit for CPUC policy compliance, IEMR results cannot be relied upon as an objective measure of Pacific Bell's regulated intrastate earnings.

# Chapter 2 - Background, Scope, Objectives and Recommendations

This chapter discusses audit background, approved objectives and scope and difficulties we encountered in performing the audit. It also contains audit recommendations. Many of the recommendations address New Regulatory Framework (NRF) monitoring reports, particularly those intended to monitor financial and ratemaking-adjusted results. Recommendations also address accounting for affiliate transactions, compensation for Pacific Bell for the transfer of its advanced services business to an affiliate, compensation for customer data Pacific Bell may share with affiliates, and changes in non-regulated allocation procedures. All audit recommendations are directed to the Commission.

# I. Audit Background

This is the first comprehensive regulatory audit of Pacific Bell since the Commission implemented the New Regulatory Framework in 1990. The audit was initially ordered at the conclusion of the first NRF triennial review. In Decision 94-06-011 the CPUC ordered the Division of Ratepayer Advocates (DRA) to file a plan for "an inspection of the books and recorded of Pacific . . . pursuant to Public Utilities Code Section 314.5." In Decision 95-06-036, the CPUC ordered the Division of Ratepayer Advocates (DRA) to develop an audit workplan. As guidance, the Commission provided the following clarifying directives for objectives and scope:

The CPUC objective is to obtain the results of a thorough, aggressive audit. Depth and scope should be consistent with the CPUC policies of opening telecom markets, reducing the burden of regulation, and NRF reliance on price-cap regulation.

The services we are authorizing . . . are limited to an in-depth audit on an account-by-account basis with appropriate detailed follow up. The resulting work product should include an analysis of all issues uncovered, including any relevant documentation.

In March, 1999 the Office of Ratepayer Advocates (ORA), DRA's successor organization, issued a Request for Proposals to perform the Pacific Bell audit. The RFP indicated the audit was to include "a comprehensive review of [Pacific Bell] and affiliate procedures, policies, practices for the period January, 1996 through December, 1998." The general objective was to "provide current, relevant information regarding Pacific Bell's operational and financial processes to assist the CPUC in regulation." The tasks listed in the RFP included analyzing Pacific Bell's NRF monitoring reports, cost allocations, and accounting procedures to ensure against any cross subsidization or anti-competitive behavior, determining whether Pacific Bell and its affiliates were following CPUC affiliate transactions rules, and determining whether non-structural safeguards adequately protected ratepayer and competitor interests regarding non-regulated activities.

In June, 1999, after contractor proposals were submitted and ORA selected finalists, Pacific Bell filed a motion to suspend award of the audit contract. Pacific Bell stated that the RFP went beyond the Commission's authorization and guidelines and requested the Commission review any audit plan. Pacific Bell also asked that audit oversight be transferred from ORA to the Commission's Telecommunications Division. Shortly thereafter, Overland Consulting was awarded the contract to perform the audit. In July,

<sup>&</sup>lt;sup>1</sup> California Public Utility Code Section 314.5 states "The commission shall inspect and audit the books and records for regulatory and tax purposes (a) at least once in every three years in the case of every electrical, gas, heat, telegraph, telephone and water corporation servicing over 1,000 customers."

1999 the CPUC denied Pacific Bell's motion, but ordered the Commission's Executive Director to review Overland's proposal for consistency with the clarifying directives issued in 1996. This review produced three minor modifications in the proposed work.<sup>2</sup>

Pacific Bell's effort to shift the supervision of the audit away from ORA continued after the Commission denied its June, 1999 motion. In February, 2000, the Commission reassigned audit oversight from ORA to the Commission's Telecommunications Division (TD).<sup>3</sup> A brief history of the litigation of the audit is set forth in Attachment 2-1.

In April, 2000, we conducted an audit kickoff meeting with Pacific Bell and the TD staff. As a result of delays in starting the audit, Overland, TD and Pacific Bell agreed to update the audit period to the three year period 1997 through 1999. In June, 2000, after working through scheduling details with Pacific Bell, we held our first technical audit meeting with Pacific Bell subject matter experts. It took approximately 6 months to complete preliminary audit work and approximately one year to complete detailed audit work and produce a draft audit report. At the conclusion of preliminary work, we prepared a risk analysis to assess areas that warranted detailed review. A copy of the risk analysis is presented in Appendix 2-1.

# II. Audit Scope and Objectives

Approved audit objectives and scope included the following:

### • Regulated Financial Reporting

- •• Determine compliance with CPUC accounting policies.
- •• Restate audit period intrastate regulated earnings to correct accounting errors and properly reflect CPUC accounting and ratemaking policies.
- Explain significant factors impacting audit period intrastate regulated earnings.

### • Affiliate Transactions

- •• Determine compliance with CPUC affiliate transaction rules.
- Determine whether current affiliate transaction procedures are sufficient to ensure crosssubsidies are avoided.
- •• Assess the adequacy of affiliate transaction internal controls.
- Determine how organizational and business changes have affected Pacific Bell.
- Determine whether affiliate transactions were properly recorded in regulated accounts.

#### Assignment and Allocations to Non-Regulated Telco Operations

- Document the non-regulated assignment / allocation framework and compare with CPUC fully distributed cost distribution requirements.
- Assess the adequacy of internal controls.
- •• Conduct a detailed analysis of non-regulated cost assignment and allocation procedures.
- Consider the potential for cross subsidization between SBC regions, service categories, and services.

<sup>&</sup>lt;sup>2</sup> The modifications were 1) we were not to review the sale of Bellcore or 2) the SBC/Ameritech merger. 3) We were not to interview regulatory agencies, competitors or other interested parties about Pacific Bell's practices or affiliate relationships. The modifications did not change the audit objectives, and had a minor impact on audit scope.

<sup>&</sup>lt;sup>3</sup> The transfer of oversight to TD did not change our approach to the audit.

#### • NRF Monitoring

- •• Determine if Pacific Bell submitted timely and accurate monitoring reports.
- •• Recommend new reports to address changing regulatory, technological and competitive telecommunications environments, changes to make existing reports more useful and deletion of obsolete reports.

Audit scope and objectives were the subject of considerable debate and litigation. Attachment 2-2 is a discussion of how the approved audit scope and objectives evolved. Ultimately, the areas we were able to audit and the objectives met were shaped not only by the approved list of objectives, but also by the data Pacific Bell was willing and able to provide, the amount of time it took to acquire responses to data requests, and by the calendar time available to complete the audit. Although the calendar acted as a constraint, the TD staff gave us sufficient flexibility to successfully meet most audit objectives. Given the difficulties we encountered in obtaining data, without this flexibility our ability to accomplish objectives would have been significantly reduced.

## A. Factors Affecting the Performance and Completion of the Audit

The audit was time consuming and labor intensive, taking 18 months to complete, six months longer than initially estimated. Most audit objectives were met, but some were not. The key factors affecting the time it took to complete the audit and our ability to meet objectives are described below:

- Pacific Bell's Attempts to Define Data Relevancy and Limit Audit Scope Pacific Bell imposed restrictions on the data it considered to be relevant and within the audit scope. It was clear from litigation prior to the audit that Pacific Bell did not believe the audit should include the review of affiliate transactions set forth in the Commission's Request for Proposals.<sup>4</sup> The company carried this point of view into the audit itself, at one point indicating it would not answer requests for data it perceived to be related to affiliate transactions and asking that affiliate transactions data already provided be returned. At various times, Pacific Bell imposed restrictions on the time periods that requested data could cover. A theme running throughout these restrictions was the company's contention that data created in or relating to periods other than the years 1997 through 1999 was outside the scope of the audit. When data relating to periods outside the 1997-1999 time-frame was provided, it was at Pacific Bell's discretion and based on Pacific Bell's, not the audit team's, judgement as to what was relevant.
- 2. <u>Data Request Turnaround Time</u> In April, 2000, we met with Pacific Bell and the TD staff to establish ground rules for conducting the audit. At the time, Pacific Bell agreed to target 10 days as the maximum time to respond to data requests, with quicker turnaround for "off the shelf" requests. As of January 7, 2002, the average age of data responses (both answered and unanswered) was 75 days, more than seven times the agreed-upon target. 200 data requests

<sup>&</sup>lt;sup>4</sup> In litigating this issue prior to the audit, Pacific Bell asserted that ORA's original Request for Proposals was "inconsistent with the Commission's directions as set forth in Decision 96-05-036", in part because the RFP referred to the CPUC's statutory authority under California Public Utilities Code Sec. 797 that had not been discussed in the Decision ordering the audit. (See I.87-11-033, Pacific Bell's Emergency Motion to Suspend Awarding of an Audit Contract, June 15, 1999, p.6). We note the following: 1) After Pacific Bell's Emergency Motion and a subsequent Commission Decision, the Commission's Executive Director approved a revised audit proposal that included most of the affiliate transactions work requested by ORA in its RFP; 2) Public Utilities Code Section 797 requires the CPUC to "periodically audit all significant transactions . . . between a . . . telephone corporation and every subsidiary or affiliate . . . "; and 3) prior to this audit, Pacific Bell's affiliate transactions had not been reviewed since the New Regulatory Framework was implemented in 1992.

remained outstanding, 155 of which had an average age of more than 5 months.<sup>5</sup> More than any other factor, Pacific Bell's inability and / or unwillingness to provide data within a reasonable period after receiving a written request degraded the efficiency of the audit and caused it to consume more calendar time and effort than originally budgeted. Throughout the audit we managed the inventory of data responses using our computerized data log application, with the assistance of the CPUC's TD staff. We conducted status meetings with Pacific Bell every two weeks to encourage the company to respond to specific requests and to measure data response progress. We tracked the timeliness and responsiveness of data received in the data log. Without continuous data management and the assistance of the TD staff, a majority of audit objectives would not have been met. Even with the data management effort there were data requests that Pacific Bell would not answer. Copies of our data status reports are included in Appendix 2-2. A copy of the final data log update prior to the release of our report is included in Appendix 2-3.

- 3. <u>Inability or Unwillingness to Provide Data</u> Pacific Bell was unable or unwilling to supply some of the data necessary to complete audit objectives. Examples include:
  - Support for contingent liability costs and regulatory cost accruals factoring directly into the calculation of CPUC-regulated earnings.
  - Service-specific revenue data; for example, revenue from sales of caller ID
  - Cost support for affiliate transfer prices.
  - Affiliate-specific functional organization charts
  - •• Practices and policies relating to the sharing of telephone company customer data with unregulated affiliates.
- 4. Objections to Providing Data Pacific Bell alternated between objecting to and providing data covering periods outside the 1997 to 1999 audit time frame. Pacific Bell objected to questions on some subjects. At one point during the audit, Pacific Bell declared a moratorium on responses concerning affiliate transactions and requested data already provided to be returned.
- 5. Incomplete and Non-responsive Answers A number of data responses were incomplete or not responsive to our requests. In some cases, it took several months and several attempts on our part to complete a data response. We classified a number of responses as complete non-responsive. In these cases, which usually involved some response on Pacific Bell's part, we determined that Pacific Bell was unlikely to provide all of the data specifically requested.
- 6. <u>Unanswered Data Requests</u> In some cases, Pacific Bell simply left requests unanswered. For example, as discussed above, we asked Pacific Bell to describe its policies with respect to sharing customer information with affiliates. Pacific Bell did not object to the requests; yet, after more than six months, the requests remained unanswered.

<sup>&</sup>lt;sup>5</sup> Data Status Report, January 7, 2002. This was the last data status report prior to the completion of the audit report.

## III. Audit Recommendations

We consolidated all audit recommendations into this chapter. Recommendations are organized by major audit report section. Due to the nature of the audit, recommendations are directed to the Commission, rather than Pacific Bell. In doing so, it is our intention that the Commission direct Pacific Bell to implement the recommendations it finds should be adopted.

# A. Monitoring - Financial and Operational Reporting

We found CPUC-basis financial reports provided during the audit period were confusing and lacked necessary disclosures. Due to complexities associated with CPUC financial reporting and the specific changes needed to make the Pacific Bell's regulatory financial reports usable and understandable, the recommendations described below are detailed. Most of the recommendations in this section are based on an assumption that the Commission will continue to monitor Pacific Bell's regulated earnings and require Pacific Bell to produce financial results consistent with CPUC accounting policies.

- 1. The Commission should consider whether Pacific Bell's process for obtaining and reporting IEMR results is consistent with the NRF goal of simplifying and streamlining the regulatory process. As discussed in Chapter 3, Pacific Bell's audit period regulated earnings calculations were the product of a complicated and confusing process that 1) began with Pacific Bell's FCC -basis results, 2) added Pacific Bell subsidiaries, various "jurisdictional" adjustments and consolidating eliminations to obtain CPUC-basis financial results and 3) removed subsidiary amounts, interstate costs and non-regulated allocations and added various "ratemaking" adjustments to calculate regulated earnings. In addition to being complicated, during the audit period the components of the process were poorly disclosed. To meet the NRF goal of streamlined regulation and to shed light on the many financial and ratemaking adjustments embedded in various stages of the process, the Commission should consider whether the process should be simplified. For example. CPUC-basis financial statements that serve as an intermediate stage between FCCbasis separate and the IEMR could be eliminated (to our knowledge they were never ordered by the Commission in the first place). Instead, "jurisdictional" adjustments to FCC-basis financial results (some of which are actually ratemaking adjustments) could be incorporated into the IEMR. FCC-basis financial results, which are already compiled on a Pacific Bell stand-alone basis, would then form the foundation for the IEMR, eliminating unnecessary steps and enhancing the understandability of IEMR results.
- 2. To the extent separate FCC and CPUC regulatory statements continue to be presented and are similarly titled, they should be presented in a consistent manner, preferably on a Pacific Bell stand-alone basis. If subsidiary results are included in financial results, the subsidiaries should be disclosed in the title or in notes to the statements. During the audit period Pacific Bell's MR (FCC-basis) financial statements reflected Pacific Bell on a stand-alone basis. FR (CPUC-basis) reports, although similarly entitled "PB California", contained results for Pacific Bell consolidated with different mixtures of subsidiaries. The changes from year to year were not disclosed, nor was pro-forma information provided for comparison purposes. Subsidiary results should not be

<sup>&</sup>lt;sup>6</sup>In 1997, Pacific Bell's FR reports contained the consolidated results for Pacific Bell, Pacific Bell Information Systems (PBIS), Pacific Bell Directory, Pacific Bell Development, Pacific Bell Wireless, Pacific Bell Internet and Pacific Bell Network Integration. In 1998, FR reports included consolidated results only for Pacific Bell and PBIS. FR data used as input to the 1999 Intrastate Earnings Monitoring Report (IEMR) reflected consolidated results for Pacific Bell and PBIS, while FR results in the 1999 Results of Operations report reflected Pacific Bell by itself.

included in Pacific Bell's CPUC-basis statements, particularly when they are excluded from the FCC-basis financial statements. At a minimum, common sense suggests that any subsidiaries included in financial statements that are entitled "Pacific Bell" or "PB California" be clearly identified.

- 3. If Pacific Bell continues to maintain separate MR (FCC-basis) and FR (CPUC-basis) financial results, all adjustments explaining differences between the statements should be fully disclosed and the basis for each adjustment should be fully explained in notes or analytical documentation accompanying the FR statements. Pacific Bell should annually provide a complete set of support for "C3" ("jurisdictional") adjustments that reconcile FCC-basis and CPUC-basis financial results. Support should include descriptions and full calculation support for each adjustment. Pacific Bell's financial transactions are initially recorded on an MR (FCC) basis. During the audit period there were significant differences between FCC-basis and CPUC-basis financial statements. Some were presentation differences caused by including different sets of subsidiaries in MR and FR results. Apart from the presentation differences were real differences resulting from C3 (FCC to CPUC) financial reporting adjustments. Many of the C3 adjustments were caused by differences in FCC and CPUC accounting requirements. However, some were ratemaking adjustments made by Pacific Bell at its own discretion. The ratemaking adjustments were not disclosed and partly explain Pacific Bell's understated IEMR earnings and lack of reported shareable earnings. Assuming the Commission believes it needs separate CPUC-basis financial statements, the only effective way to monitor them is to 1) have FR (CPUC) and MR (FCC) results presented side-by-side on a comparable basis (i.e. a basis in which both reports contain results for the same set of subsidiaries), 2) maintain an understanding of the nature and magnitude of jurisdictional differences between FCC and CPUC reporting, and 3) be able to distinguish between adjustments resulting from jurisdictional accounting differences and discretionary adjustments designed to meet regulatory objectives (the latter are ratemaking adjustments that should be included in the IEMR). The problems discussed in this recommendation are not corrected by Resolution T-16545 adopted in August, 2001.7
- 4. Pacific Bell's Intrastate Earnings Monitoring Report (IEMR) should reflect Pacific Bell's results on a stand-alone, CPUC (FR) basis Pacific Bell's audit period IEMR was unnecessarily confused by the inclusion of subsidiary results in the FR (CPUC-basis) financial data entered into the first column of the report. Subsidiary results should be excluded from the "Total California Operations" data input into Column 1 of the IEMR.
- 5. IEMR "intrastate ratemaking adjustments" should be supported by a separate schedule breaking out the amounts associated with each adjustment and by descriptions of the basis for each adjustment and the CPUC authority for making it. Audit period IEMRs contained a number of

In fact, by approving Pacific Bell's request to eliminate 13 financial monitoring reports in Resolution T-16545 in August, 2001, the CPUC may have unknowingly eliminated its ability to see even the magnitude of the differences between FCC-basis and CPUC-basis results. Among the 13 monitoring reports no longer required are those containing MR (FCC-basis) results: PD-01-14, the MR summary of reports; PD-01-15, the MR income statement; PD-01-016, the MR balance sheet and PD-01-19, the FR summary of reports, part of which (PD-01-19a) showed MR and FR results side-by-side. The new USOA Summary Report approved in Resolution T-16545 is not specified to provide MR results or MR / FR differences. *At a minimum*, Pacific Bell should be required to provide comparable (preferably Pacific Bell stand-alone) MR and FR results as separate columns in the new USOA Summary Report, in addition to the support for C3 adjustments.

ratemaking adjustments that were incorrectly referred to in the plural as "disallowances." Most of the ratemaking adjustments in the report were squeezed into a column labeled "Other Misc." IEMRs provided no documentation of the adjustments in the "Other Misc" column. IEMR ratemaking adjustments should be broken out on a separate schedule and the basis and CPUC authority for including them in the IEMR should be provided in a narrative description.

- 6. Pacific Bell should annually provide workpaper support for "intrastate ratemaking adjustments" with calendar year-end IEMR results. Overland obtained workpaper support for IEMRs in response to Data Request OC-66. This support should be filed with the year-end IEMR to enable the CPUC staff to understand how Pacific Bell computed its CPUC-regulated earnings. We recommend that the CPUC staff tie Pacific Bell's IEMRs to supporting workpapers, review IEMR and C3 adjustment workpapers and obtain an understanding of C3 adjustments, IEMR ratemaking adjustments and regulated earnings calculations at least once per year.
- Pacific Bell should provide the CPUC staff an electronic spreadsheet download of monthly trial balance data providing account, sub-account and EXTC detail for Pacific Bell (on a stand-alone basis) and Pacific Bell Directory (PBD) in support of year-end IEMR results. A trial balance is critical for understanding financial results and detecting significant fluctuations at the account and sub-account level. Electronic trial balances in spreadsheet format are easy to prepare, download, send and review and take up almost no space. We obtained electronic versions of trial balances for this audit. The Commission should require that trial balances tie to the amounts in column 1 of the IEMR. PBD trial balance data should tie to the amounts in the "Directory" column of the IEMR.
- 8. Pacific Bell's Annual Report on Significant Affiliate Transactions (O.I.R. report) should be designated as a monitoring report. To the extent its content duplicates the content of existing monitoring reports covering affiliate transactions, the other reports should be eliminated. We found duplication between some of the affiliate transaction data required in the monitoring program and Pacific Bell's annual O.I.R. report in the areas of employee transfers and company procedures. The requirements for the O.I.R. report cover most of the key data needed to monitor affiliate transactions. Pacific Bell and the CPUC staff should compare notes on affiliate transactions data provided to the monitoring program. Monitoring reports that duplicate what is provided in the O.I.R. report should be eliminated and replaced by the O.I.R. report. The Commission should consider asking the CPUC staff to carefully review the content of the O.I.R. report and order additional information as necessary to properly monitor the affiliate relationships that have evolved and increased since the end of the audit period.
- 9. Pacific Bell's O.I.R. report should provide organizational data that reflects the affiliate structure used in intercompany billing and financial reporting. The organizational data provided in O.I.R. reports during the audit period consisted of a list of legal entities. It contained no organizational structure information and was not filed on a timely basis. Pacific Bell's organization can be defined in several dimensions (legal, payroll, management, and inter-company accounting). Pacific Bell should continue to provide the listing of legal entities it provided during the audit period with the O.I.R report, but should do so on a timely basis with the rest of the report. In addition, Pacific Bell should provide management organization charts reflecting the department

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<sup>&</sup>lt;sup>8</sup> Some of the adjustments added to reported expense or subtracted from reported revenue, and were, in fact, the opposite of a "disallowance".

<sup>&</sup>lt;sup>9</sup> We include PBD's trial balance data in the recommendation because it is treated like a department of Pacific Bell for the purpose of calculating regulated earnings on the IEMR.

structure of the entities defined for *inter-company accounting and billing purposes* (for example, the departments of the parent entity whose costs are billed to Pacific Bell through the parent's billing model). This is necessary to permit an understanding of the organizations behind the intercompany transactions presented in other sections of the O.I.R. report.

- 10. Pacific Bell should adjust and reissue 1997 through 2001 FR (CPUC-basis) financial statements and IEMRs to reflect the Commission's Findings of Fact and Conclusions of Law with respect to audit adjustments and accounting issues discussed in this report. Pacific Bell should adopt accounting practices necessary to reflect audit period adjustments adopted by the Commission in years after 2001. The adjustments resulting from this audit were made necessary by a failure to maintain accounting in accordance with CPUC rules. These adjustments will continue to affect CPUC-basis financial results in the years after the audit period unless the Commission orders the adjustments to be implemented in financial results for years after 1999. To the extent the Commission adopts audit recommendations that require a change in Pacific Bell's audit period accounting procedures, Pacific Bell should adopt the change to comply with the Commission order. Because 2000 and 2001 accounting will be complete by the time a Commission order is issued, Pacific Bell should restate 2000 and 2001 CPUC-basis financial results as required to bring these results into compliance with the Commission's order. CPUC-basis financial results and IEMR results for the 1997 - 1999 audit period should also be restated to comply with the Commission order.
- 11. Pacific Bell should provide stand-alone actuarial reports, certified by SBC's independent actuary, for the Pacific Bell component of SBC employee benefit plans. The 1999 merger of Pacific Bell's management pension plan into the SBC management pension plan creates the risk that Pacific Bell's pension costs will be overstated because of the misallocation of assets and liabilities. The 1999 actuarial report for the SBC management pension plan provides only limited summary information for the Pacific Bell component of the overall SBC management plan. Preparing standalone Pacific Bell actuarial reports each year will promote the tracking of Pacific Bell's pension assets and liabilities on a consistent basis, discourage and help to identify transactions that effectively transfer pension assets funded by Pacific Bell's regulated customers to cover pension liabilities in other SBC subsidiaries, and provide the full disclosures required by generally accepted actuarial principles and practices.
- Cash Working Capital should be excluded from future IEMR reports. Cash working capital requirements are not recorded on Pacific Bell's books. Instead, they are calculated in complex lead-lag studies prepared exclusively for IEMR purposes. The amount of time required to audit Pacific Bell's cash working capital studies is disproportionate to the impact of cash working capital on rate base. Pacific Bell's cash working capital studies were particularly difficult to audit because of the lack of support for the factors used in the studies and the numerous errors made by Pacific Bell. Auditing the cash working capital allowances claimed by Pacific Bell is simply not practical under the existing IEMR review process. Pacific Bell's corrected cash working capital averaged \$147 million during the audit period (before consideration of outstanding data requests). Based on the audit results, excluding cash working capital from rate base will not result in a material misstatement of rate base. Accordingly, we recommend that cash working capital be excluded from rate base in future IEMR results.

## B. Monitoring - Competition, Technology and Service Quality

- The CPUC should evaluate the types of statistics it needs to monitor competition and consider developing a program to monitor the progress of local exchange competition. In recent years the CPUC and the FCC have taken steps intended to make local exchange markets competitive. The introduction of competition is the basis most often cited to support the reduction or elimination of traditional cost and price regulation for incumbent local exchange carriers. SBC cites local exchange competition as justification for being allowed into the interLATA long distance market. In recent years regulations have been implemented to open the network to local exchange competitors. During this period Pacific Bell had significant NRF requirements, such as customer earnings sharing, suspended. Although SBC asserted in a "Competitive Environment Report" filed with the CPUC that the local exchange is "highly competitive", our review showed that the CPUC's monitoring program produces almost no information to permit an objective evaluation of competition or the progress competing companies have made in penetrating local exchange markets. The CPUC should consider revising monitoring program requirements to incorporate objective market share data and data concerning competitors' use of Pacific Bell's network.
- 2. The CPUC should consider monitoring SBC's, PTG's and / or Pacific Bell's ownership interests in and management control of California competitive local exchange providers. Recent events surrounding Covad Communications provide an example of why it may be important for the CPUC to monitor SBC's acquisition of California competitors in order to meet its NRF objective of opening local exchange markets to competition. Covad competes with SBC in the broadband services market, providing digital subscriber line, virtual private networking and virtual internet provider services. On December 13, 2001, as a part of a plan to emerge from bankruptcy, Covad announced that SBC would make a \$150 million investment in the company Covad announced the investment as an "equity infusion." The benefits of competition can be negated if competitors are simply purchased or otherwise controlled by the incumbent provider with which they are intended to compete. We recommend that the CPUC consider a monitoring report tailored to track the ownership and management control relationships between SBC and other companies certified to provide local exchange telecommunications in California. This would help the Commission determine whether companies other than SBC in the California local exchange market are bona fide competitors.
- 3. Pacific Bell should provide the unit data required in report PA-03-00 Market Penetration Data for Category II Services so that the report can serve its intended purpose. Category II services are services for which competition is emerging and Pacific Bell is granted some pricing flexibility. The data Pacific Bell filed for this existing monitoring report was limited to revenue. Without unit data, the report cannot be used to assess market penetration for Category II services, as implied by the report title.
- 4. The CPUC should consider whether it is worthwhile to have Pacific Bell continue filing service-specific embedded cost reports. If the CPUC determines that it needs the reports, Pacific Bell

<sup>&</sup>lt;sup>10</sup> Yahoo Finance, Profile, Covad Communications, Business Summary, December 19, 2001.

<sup>&</sup>lt;sup>11</sup> Reuters, "Update 1 - Covad Expects to Exit Bankruptcy on Dec. 20", December 13, 2001.

<sup>&</sup>lt;sup>12</sup> CNBC, Power Lunch, December 19, 2001. CNBC described SBC's \$150 million investment as an "equity infusion".

should be required to resume maintenance of the Profitability Information (PI) system used to produce them. If the reports are not used, they should be eliminated. Service-specific embedded cost study reports comprised approximately half the reports filed under the monitoring program during the audit period. It is not clear whether these reports are useful. They are not used directly as a basis for service pricing. For several years, Pacific Bell has continued to send copies of the reports to the CPUC but has not maintained the computer system used to produce them. As a result, the reliability of the reports is questionable. The CPUC should consider eliminating the reports from the monitoring program. If the reports continue to serve a purpose, Pacific Bell should maintain the PI system used to produce them.

Pacific Bell should file customer survey data required by the monitoring program in report PA-02-03. The Commission should consider developing a basic set of customer survey statistics designed to help it measure and detect trends in Pacific Bell's service quality. Customer surveys can serve as a barometer of service quality and customer satisfaction and help the Commission determine whether and how relaxed regulation and competition have affected service quality. The NRF monitoring program requires Pacific Bell to file customer survey results as surveys are initiated. Pacific Bell conducted customer surveys during the audit period but did not file the results as required. Pacific Bell also refused to make its customer survey results available for our review in this audit. We recommend the Commission reiterate Pacific Bell's existing requirement to file surveys and obtain copies of the results of surveys conducted during and since the audit period. We also recommend the Commission consider requiring Pacific Bell to obtain customer survey data specifically designed to monitor statistics historically used by the CPUC staff to measure service quality.

## C. Affiliate Transactions Accounting

1. SBC should maintain Part 32 account translation detail for all affiliates allocating cost to Pacific Bell and for all subsidiaries that may be combined with Pacific Bell for financial reporting purposes. Pacific Bell should make use of account translation detail to accurately record affiliate charges from shared services subsidiaries in the correct Part 32 accounts, and to accurately classify subsidiary financial results in consolidated financial reports it may provide to the CPUC. Pacific Bell's costs for services provided by affiliates grew seven-fold between 1996 and 2000. By 2000 affiliate services accounted for approximately 25 percent of Pacific Bell's operating expenses. Trends suggest affiliate transactions will comprise a growing portion of Pacific Bell's expenses in the future. During the audit period Pacific Bell began to transfer several large telco functions (customer service, marketing, information technology) to shared services affiliates such as SBC Operations and SBC Services. These affiliates allocate their costs back to Pacific Bell but do not maintain their books using the FCC Part 32 Uniform System of Accounts (USOA). Neither the shared services affiliates nor Pacific Bell were able to provide support demonstrating that affiliate accounting data was accurately translated to Pacific Bell's Part 32 accounts in the affiliate transaction process. In addition, Pacific Bell incorporated general ledger results for subsidiaries into Pacific Bell's financial reporting system for the purpose of presenting consolidated FR (CPUC-basis) results. Pacific Bell indicated in response to our request that detail for translating financial data from subsidiaries such as Pacific Bell Information Systems and Pacific Bell Network Integration was unavailable. 13 Pacific Bell should maintain an audit trail (specifically, a detailed account translation table, also known as an account mapping) to ensure that affiliate charges and subsidiary financial results accurately translate to the Part 32 USOA.

<sup>&</sup>lt;sup>13</sup> Response to OC-622

The fact that Pacific Bell could not provide this data casts doubt on the reliability of the translation of affiliate costs into Pacific Bell's accounts during the audit period.

- 2. Pacific Bell should maintain the unique identity of the types of costs it receives from affiliates, particularly for those functions historically performed by Pacific Bell. This could be accomplished by requiring Pacific Bell to follow its expenditure-type-code (EXTC) structure for all costs of services provided by affiliates based on the nature of the affiliate's underlying costs. As Pacific Bell transfers an increasing number of its telephone company functions to affiliates, it is losing much of the financial detail that Part 32 accounting requires. In addition to the functional groupings established in the USOA account structure, Part 32 accounting calls for the maintenance of subsidiary record categories such as salaries and wages, benefits, rents, etc. (types of costs). This requirement is referred to as the "expense matrix". In Decision 87-12-063 the CPUC ordered "a separate and unique sub-account" (e.g., function code, reporting code, or expenditure code) to be set up to record the affiliate costs chargeable for each Part 32 account to which costs are assigned. 14 Rather than maintain an accounting field to separately track the type of cost in conformance with the Part 32 expense matrix, in many cases Pacific Bell aggregated affiliate charges in the same sub-account and same expenditure type code within the Part 32 account in which it recorded the affiliate transactions. As a result, the underlying identity of the types of costs from affiliates was "lost" to Pacific Bell. We do not believe the intent of the 1987 decision was to permit Pacific Bell to arbitrarily discontinue the use of expense-matrix accounting (or, for that matter, expenditure-type-code accounting) simply because telephone company functions were transferred to affiliates that do not use Part 32. We recommend the Commission require Pacific Bell to continue maintaining the financial detail required by Part 32 (including expense matrix detail) for functions performed for the telephone company, regardless of the affiliate status of the employees performing the functions.
- 3. The parent company should stop billing Pacific Bell for costs identified with charge code 80 Mergers, which are not attributable to Pacific Bell. In the alternative, if the parent continues to bill the costs, it should specifically identify the costs in supplemental billing information and Pacific Bell should record them below-the-line. Beginning in 1998, MSI began billing subsidiaries including Pacific Bell for merger and acquisition costs incurred by the parent company's Corporate Development organization. During the audit period most of these costs related to unsuccessful acquisition scouting projects in other countries. Under attributable cost principles these costs should not be charged to Pacific Bell. Because they are not separately identified on Pacific Bell's affiliate bill, they cannot be isolated for below-the-line accounting treatment. MSI should stop billing these costs to Pacific Bell and Pacific Bell Directory. In the alternative, MSI should separately identify the charges and Pacific Bell should record them below-the-line in account 7370 Special Charges.
- 4. Account 7370.39 Special Charges Lobbying should be the default account for the parent company's California Regional External Affairs departments. Alternatively, the CPUC should consider requiring an IEMR adjustment to remove "lobbying" expenses from account 6722 External Relations. During the audit period, the costs of MSI's California Regional External Affairs organization were automatically directed to above-the-line account 6722 External Relations, unless exception time reporting was employed. The predominant objectives of the California regional external affairs departments meet the FCC definition of "lobbying", requiring the associated cost to be recorded in below-the-line account 7370. Because the departments

<sup>&</sup>lt;sup>14</sup> D.87-120-63 (Ordering Paragraph 14a.)

failed to use the project codes available to properly classify costs for below-the-line account treatment, costs that should have been recorded below-the-line were instead recorded in account 6722. The account to which a department's costs are automatically directed should be one reflecting the department's predominant activities. In the regional departments of California's parent company external affairs organization, activities qualifying for above-the-line account 6722 are the exception rather than the rule. In these departments, costs should default to below-the-line account 7370.39, and exception time reporting and accounting should apply to above-the-line account 6722. The easiest way to implement this would be to hard-code the appropriate lobbying, legislative advocacy and political action committee project codes into timesheets, payment vouchers and other accounting source documents. In theory, this would prevent costs from being charged above-the-line unless exception coded. <sup>15</sup> To the extent the parent company's External Affairs department does not account for activities in accordance with FCC rules in the future, the Commission should consider requiring Pacific Bell to make an IEMR adjustment to remove the cost from the calculation of IEMR regulated operating income.

The parent company should provide affiliate billing support for legal expenses to enable Pacific Bell to determine that legal billings are properly assigned to Pacific Bell and can be properly divided between customer (above-the-line) and shareholder (below-the-line) categories. Pacific Bell should use this information to divide legal costs between customers and shareholders on its FR (CPUC-basis) books. To the extent the nature of parent legal costs is either unavailable or not provided with affiliate billings, they should be recorded below-the-line on the FR books. Most of Pacific Bell's legal costs reflect billings from the parent company, which houses the legal department. Costs recorded in above-the-line account 6725 (Legal Expense) increased from \$22 million in 1996 (the year before the SBC / PTG merger) to \$85 million in 2000. <sup>16</sup> Some of the cost increase was caused by the addition of a second legal department (SBC's) to Pacific Bell's cost allocations after the SBC / PTG merger. It is likely that some of the increase was caused by factors such as local exchange competition and SBC's initiative to implement intraLATA long distance. Some of these costs may not have been attributable to Pacific Bell or its regulated services customers.

Pacific Bell indicated in data responses that the parent company did not maintain a centralized project-based accounting for legal expenses. No information on the nature of parent legal expenses was provided in Pacific Bell's parent company billing. Discretionary project codes used by the parent company to track certain outside legal costs were not used for internal legal efforts and explanations of the nature of the legal costs that were tracked were not supplied with Pacific Bell's affiliate billings. Pacific Bell had no basis for segregating and properly accounting for legal charges that may have been attributable to shareholders, rather than customers. If legal expenses are to be properly divided between customers and shareholders and between Pacific Bell and other subsidiaries, costs must be identified and assigned on the basis of the legal efforts that give rise to them. This information must be provided to Pacific Bell and be available to Commission auditors. The best way to accomplish this is project-based accounting with full explanations of the nature of legal efforts. To the extent SBC or Pacific Bell determine that

<sup>&</sup>lt;sup>15</sup> We use the term "in theory" because during the audit period Pacific Bell failed to properly use the supplemental billing information provided by MSI to identify lobbying, legislative advocacy and political action committee charges. Implementing this recommendation would require Pacific Bell to make proper use of the supplemental data provided with parent company billings.

<sup>&</sup>lt;sup>16</sup> Per FCC Armis Report 43-03, totals before Part 64 allocation and Part 36 separation. The average recorded in account 6725 during the period 1990 through 1996 was \$31 million.

- information concerning the nature of legal efforts is privileged and cannot be shared with the Commission, it should be automatically charged below-the-line to shareholders, rather than above-the-line to regulated customers.
- 6. The parent company should provide supplemental information with Pacific Bell's affiliate billing to identify corporate sponsorship payments and corporate public relations, both of which are image advertising expenses not recoverable through regulated earnings. Pacific Bell should record corporate sponsorship expenses in the correct Part 32 account. The CPUC should instruct Pacific Bell to remove parent billings of corporate public relations and corporate sponsorships from regulated expense for the purpose of calculating regulated intrastate earnings on the IEMR. After the SBC / PTG merger, the parent company billed Pacific Bell more than \$10 million annually for corporate sports and cultural sponsorships and more than \$8 million annually for corporate public relations consulting services. Corporate sponsorships are a form of corporate image advertising. Contrary to FCC Part 32 requirements, Pacific Bell recorded corporate sponsorships in Account 6613 - Product Advertising. In 1986, the CPUC determined that corporate public relations expenses were a form of image advertising. The CPUC has prohibited Pacific Bell from recovering image advertising through regulated expense. Contrary to CPUC requirements, Pacific Bell included corporate sponsorship and corporate public relations expenses in regulated earnings calculations. In order to correctly account for these costs, Pacific Bell needs the information broken out in a supplement to the parent company's affiliate billing. We recommend the Commission require Pacific Bell to obtain this information. We also recommend the CPUC instruct Pacific Bell to remove these costs from regulated expense in future IEMRs.
- 7. The parent company should provide supplemental affiliate billing information identifying Pacific Bell's share of executive compensation costs exceeding the CPUC's recovery limit. Pacific Bell should use this information to eliminate "excess" executive compensation from regulated expense on the IEMR. During the audit period Pacific Bell made an IEMR adjustment to remove "excess" executive compensation from regulated expense for regulated earnings measurement. However, Pacific Bell did not have the information it needed to properly calculate the "excess" compensation flowing from parent company billings. We recommend Pacific Bell obtain the following supplemental information for each SBC executive whose total compensation exceeds the CPUC's regulated cost recovery limit: 1) total compensation included on the parent's general ledger (which should include salary, bonus, "retention", short and long term incentive, supplemental (non-qualifying) retirement, severance and post-severance "consulting" pay); and 2) the percentage billed to Pacific Bell. With this information, Pacific Bell should be able to calculate the amount exceeding the limit recoverable through regulated accounts. Executive compensation expense exceeding the CPUC limit should be recorded below-the-line to ensure recovery from shareholders, rather than regulated customers. We recommend the executive compensation limit be raised and indexed to an inflation measure such as the consumer price index. The \$200,000 limit established by the CPUC in 1986 was approximately \$300,000 when adjusted for inflation to 1998, the mid-point of the audit period. We used \$300,000 in calculating audit period adjustments to regulated earnings.

### D. Affiliate Transactions - Compensation for Business Transfers and Use of Customer Data

- 1. The CPUC should consider requiring Pacific Bell to be compensated for the "advanced services" business it transferred to SBC Advanced Solutions, Inc. If the CPUC determines Pacific Bell should be paid, it should consider whether Pacific Bell should be compensated based upon the going concern value at the time of the transfer, or whether compensation should be limited to reimbursement of Pacific Bell's development costs. In 1992, when the Commission approved Pacific Bell transfer of its information services business to PBIS, it was treated as the transfer of a business opportunity. The Commission required Pacific Bell to be reimbursed for the going concern value of the business. In 2000, Pacific Bell encountered a similar situation when it transferred its advanced services business, including digital subscriber line services (ADSL), to SBC Advanced Solutions, Inc. (ASI). During the audit period Pacific Bell charged regulated customers approximately \$200 million to develop ADSL and recorded significant ADSL investment in rate base. To the extent the transfer is not appropriately compensated, Pacific Bell has cross-subsidized ASI. The CPUC should consider whether Pacific Bell should be compensated for the transfer and whether the compensation should be based on the going concern value of the business opportunity that was transferred, as was the case with the voice mail business transferred to PBIS in 1992.
- 2. The CPUC should evaluate and develop regulatory policy governing the use of Pacific Bell's telephone company customer data by affiliates. Pacific Bell's customer list is a valuable intangible asset. In Data Requests OC-839 through OC-844 (submitted in June, 2001) we asked Pacific Bell to describe its policies for supplying customer names, telephone numbers (including unlisted and unpublished numbers) and other customer record data to affiliates. We also asked Pacific Bell whether and how it was compensated for providing the data and for copies of any available written policies relating to affiliate use of customer data. To date, Pacific Bell has not answered these questions.

Non-regulated affiliate use of customer data collected by a regulated utility raises a host of competitive, cross-subsidy and customer privacy issues. For example, if an affiliate such as Prodigy (an internet service provider in which SBC holds an ownership interest) directly or indirectly uses Pacific Bell's customer data, how much should it pay Pacific Bell? Should unaffiliated internet service providers also have access to Pacific Bell's customer data under similar terms? If not, does exclusive access to a database comprising a majority of California's telephone subscribers confer an unwarranted competitive advantage on Prodigy? If customer data is made available to affiliated and non-affiliated companies, should Pacific Bell's customers be required to provide consent or be allowed to "opt out" before having their information turned over to marketers? Should any company, affiliated or non-affiliated, be permitted to use unlisted or unpublished telephone numbers for marketing without the consent of the unlisted customer and if so, is there any value in being "unlisted"? If Prodigy or any affiliate is provided free use of customer data developed by Pacific Bell in a monopoly environment, are they being cross-subsidized in a manner contrary to CPUC rules, particularly when the CPUC requires Pacific Bell be compensated for transfers of intellectual property and proprietary information?

To complete its understanding in this important audit area, the CPUC should consider requiring Pacific Bell to fully document the customer data it has shared with or transferred to affiliates (including shared services affiliates) since the SBC / PTG merger and provide any internal policies relating to compensation for the use of the data. We recommend the CPUC determine whether and how customer data has been used for marketing on behalf of non-telco affiliates and whether unaffiliated competitors have similar access to the data. We also recommend the CPUC consider the competitive, cross-subsidy and customer privacy issues discussed above. With the

movement of the telco's customer service function to shared services affiliates, it is possible that direct control of telephone company customer data may transfer to the corporate level. Ownership of customer data may also be legally transferred to SBC without compensation to Pacific Bell. If this has occurred or could occur, the CPUC should consider whether and how much Pacific Bell should be compensated by SBC for the value of its customer list.

3. The CPUC should consider whether SBC Operations, SBC Services and / or other shared services affiliates should be required to collect the CPUC's 13 percent sales referral fees from non-regulated affiliates when they provide referral services to customers in Pacific Bell's local exchange territory. The CPUC requires Pacific Bell to charge affiliates a fee for sales referrals. During the audit period, Pacific Bell recorded a significant amount of revenue from referrals provided to affiliates such as PBIS and PB Wireless. During the audit period Pacific Bell's marketing operations were being transferred to SBC Operations and may now reside in SBC Services. During the audit period SBC Operations ran several large call centers to sell telephone company services. It is likely that these shared services affiliates used Pacific Bell's customer database to perform sales and marketing activities. As Pacific Bell transfers sales activities to shared services entities that conduct marketing and provide referrals to non-regulated affiliates, Pacific Bell's inter-company sales referral revenue will be lost unless the CPUC extends the sales referral fee requirement to the shared services entity, requiring them to collect the fees and pass them on to Pacific Bell. A properly designed fee applicable to sales referrals provided by shared services affiliates could serve as a mechanism to compensate Pacific Bell for non-regulated affiliates' use of Pacific Bell's customer database.

# E. Non-Regulated Allocation Procedures

1. The CPUC should consider whether it was reasonable for Pacific Bell to reclassify Category III ADSL service to above-the-line status. If the CPUC determines it was reasonable for Pacific Bell to move ADSL development costs above-the-line, it should consider whether, for regulatory purposes, development costs should have been deferred and amortized in periods following service deployment. Because of the magnitude of costs involved, an adjustment of 1998 and 1999 regulated operating income should be made if the CPUC determines either that ADSL's Category III status warranted below-the-line accounting treatment or that ADSL's development costs should have been amortized and matched with ADSL revenues. ADSL was introduced in 1998 but was not widely available until after the audit period. During the three year audit period Pacific Bell incurred net expenses of \$196 million to develop ADSL service and placed substantial ADSL plant investment into rate base. In 1997 Pacific Bell recorded ADSL development costs below-the-line. In 1998 Pacific Bell moved ADSL accounting above-the-line. In July, 1998, Pacific Bell filed Advice Letter 19543 with the CPUC proposing to classify ADSL as a Category III service. Although Pacific Bell requested Category III treatment, in a document attached to the proposed advice letter Pacific Bell claimed that ADSL should be accounted for above-the-line because it was a form of special access service. On September 17, 1998, the CPUC issued Resolution T-16191 giving Pacific Bell provisional authorization to provide ADSL service. The Resolution stated "TD believes at this time that ADSL is a form of special access", but did not specify that Pacific Bell should receive above-the-line accounting treatment. At the end of 1999, at about the time the service was ready to be widely marketed, Pacific Bell transferred ADSL to SBC Advanced Solutions, Inc.. As a result, regulated customers paid a substantial amount for ADSL's development, but never received the benefit of significant ADSL revenue. We have not adjusted 1998 or 1999 FRs or IEMRs to reflect a change in ADSL accounting treatment because CPUC policy was not clear. An adjustment to 1998 and 1999 regulated earnings should be made if the CPUC determines that ratepayers should not have funded ADSL costs without CPUC

- authorization or if the CPUC determines that for regulatory purposes development costs should be deferred and matched with revenues.
- 2. Pacific Bell should adhere to the FCC's Part 64 attributable cost hierarchy when assigning or allocating advertising and customer service expenses. Costs that can be directly identified with services should be assigned based on the regulated or non-regulated classification of the Pacific Bell allocated advertising agency fees, media costs, printing, postage and other advertising expenses billed by the parent company based on the time distributions of as few as two administrative employees assigned to the advertising function. Advertising should have been directly assigned to regulated and non-regulated activities based on the services for which the advertising was incurred. Information needed to assign and allocate advertising on the basis of services and business sectors advertised is readily available in parent billing detail and should be used instead of the regulated and non-regulated time distributions of administrative The regulated and non-regulated distributions of the salaries of employees administering the advertising function should be based on telephone service assignments and allocations of Pacific Bell's advertising expenses, rather than the other way around. In addition, customer service expenses, including unclassified productive and non-productive time, should follow appropriate allocation methodology based on representative productive allocation ratios.
- The CPUC should develop a policy for the treatment of costs associated with developing services marketed to customers outside the boundaries of Pacific Bell's local exchange territory. During the audit period Pacific Bell incurred costs to market telephone company services in GTE's franchised service territory. Pacific Bell charged the expenses above-the-line to customers in its own franchised service territory. Most costs that SBC incurs to develop competitive local exchange services are, or should be, charged to SBC's "National Local" (competitive local exchange company) subsidiary. The CPUC should consider whether costs incurred to develop competitive services outside Pacific Bell's franchised territory should be 1) charged to regulated services customers within Pacific Bell's franchised territory, 2) charged below-the-line, or 3) charged to the National Local (competitive local exchange) affiliate. If the CPUC determines it is reasonable for Pacific Bell to record these costs in regulated expense accounts, it should require Pacific Bell to record revenue above-the-line as well.
- 4. The CPUC should develop a policy concerning treatment of costs incurred to enter the long distance market. During the audit period Pacific Bell incurred costs to meet regulatory and operational requirements associated with entry into the interLATA long distance market. Pacific Bell charged costs incurred to enter the long distance business to regulated expenses on the telephone company's books. The revenues from providing interLATA long distance services will go to SWBT Communications, Inc., SBC's long distance subsidiary. The CPUC should consider whether it is reasonable for Pacific Bell to charge its regulated customers for costs incurred to make ready services that will provided by another affiliate.
- 5. Pacific Bell should maintain an up-to-date California Cost Allocation Manual. The California Cost Allocation Manual was out of date in the following areas: 1) PI System Descriptions; 2) Cost Allocation Table; 3) Pacific Bell Reporting Systems Flowchart; 4) Category I and II Lists of Services. It should be brought up to date each year. Although Pacific Bell acknowledged its CAM was out of date, it did not acknowledge the problem areas noted in this recommendation. If the CPUC adopts this recommendation and orders Pacific Bell to update its CAM, we recommend the Commission specifically address in its order the areas in the CAM that need to be updated.